Internal Revenue Service

memorandum

CC:TL-N-8999-86
Br1:LJFernandez

date:

to: District Counsel, Seattle CC:SEA
Attn: Larry N. Johnson

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your memorandum dated August 15, 1986, requesting technical advice with respect to the above-captioned case.

ISSUES

(1) Whether, for purposes of the T.C. Rule 155 computation, respondent correctly computed petitioners' amortization basis for their [redacted] taxable year by using the present value factors appearing in column (b), Tables IV and VI, of Treas. Reg. § 1.483-1(g)(2), in arriving at the amount of petitioners' bona fide debt.

(2) Whether petitioners' amount at risk would increase, pursuant to I.R.C. § 465, for any payments made by petitioners in subsequent taxable years, regardless of whether such payments are minimum payments on the notes or otherwise.

(3) Whether that portion of each payment made with respect to the petitioners' bona fide debt that is determined to be imputed interest under section 483 would be deductible by petitioners when paid, pursuant to sections 163 and 461, given the Tax Court's apparently contradicting statements in [redacted] at [redacted].

CONCLUSION

(1) Because the court determined that section 483 applied to that portion of petitioners' debt that was determined to be bona fide and that total unstated interest existed with respect to such bona fide debt, the correct procedure was to compute the amount of the total unstated interest. This computation is made by using column (b) in the appropriate Treas. Reg. § 1.483 tables to compute the present values of the stream of payments that compose petitioners' bona fide debt. Treas. Reg. § 1.483-1(g)(1). Therefore, petitioners erred in using column (a). Accordingly, the computation was filed as unagreed pursuant to T.C. Rule 155(b) on [redacted].

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(2) Pursuant to section 465(b)(1)(A) and Prop. Treas. Reg. § 1.465-22(a), 44 Fed. Reg. 32238 (1979), petitioners' amount at risk will increase by the amount of any cash invested by petitioners in the subject activity in subsequent years, except to the extent of that portion of any payment made toward petitioners' ECG franchise activity that represents imputed interest under section 483 in accordance with conclusion (1) above.

(3) In light of certain aspects of the court's opinion discussed below and in view of the general rule that imputed interest is deductible by a cash basis taxpayer when paid, Treas. Reg. §§ 1.483-1(a)(1) and 1.483-2(a)(1)(ii), it appears that no argument is available to deny petitioners such deduction.

FACTS

In [redacted], the petitioners bought [redacted] medical equipment franchises from [redacted] for $[redacted] per franchise; each franchise included an ECG terminal. The purchase price for each franchise was paid by delivering $[redacted] in cash and a "recourse" note for $[redacted]. [redacted] allocated the $[redacted] cash per franchise as follows:

$[redacted] = franchise fee
[redacted] = first year royalty
[redacted] = purchase price of ECG terminal

Each franchise ran for [redacted] years and was renewable for an additional [redacted] years upon the payment of a $[redacted] franchise fee. The term of each "recourse" note was also [redacted] years and a minimum payment of $[redacted] per annum was required. The $[redacted] represented [redacted]% interest on the principal balance. A note could be renewed for an additional [redacted] years on a nonrecourse basis upon payment of a $[redacted] note conversion fee. The principal portion of each note was payable out of net exploitation revenues.

The court considered all of respondent's usual "tax shelter" arguments and held, inter alia, that the bulk of each $[redacted] note did not represent true debt for federal tax purposes and that the $[redacted] minimum payments with respect to each note were not deductible interest for federal tax purposes. However, the court found that such minimum payments were fixed and unconditional and that the $[redacted] note conversion fee and $[redacted] franchise fee were likely to be paid. Therefore, the court held that the petitioners incurred bona fide debt to the extent of those payments. [redacted] at [redacted]. The court then went on to state:

[redacted]

The court then concluded that the petitioners' total investment per franchise was approximately $, i.e., the $ cash plus the approximately $ of valid debt.

The court also concluded that petitioners' depreciable basis in each franchise was limited to its fair market value of $. The remainder of petitioners' $ investment per franchise ($) was allocable to intangible franchise rights which could be amortized over a year useful life. at .

With regard to respondent's section 465 argument, the court determined that the petitioners were not at risk for any portion of each $ note. The court held that the bulk of each note that was not true debt for federal tax purposes could not be included in petitioners' at risk amount for that reason. Further, such portion would also fail under section 465(b)(4). at . The court also held that even the portion of each note that was determined to be bona fide debt could not be included in petitioners' amount at risk pursuant to section 465(b)(3) because had an interest in petitioners' activity other than as a lender. at . Therefore, petitioners' amount at risk was limited to their $ per franchise cash investment.

In light of the provisions of the opinion discussed above, a T.C. Rule 155 computation was prepared. In arriving at the adjustment to petitioners' income to reflect the amortization of franchise costs, respondent computed the amortization basis per franchise as follows:

Down payment	=	$
Bona fide debt	=	
Less: Basis of depreciable assets	=	
Amortization basis	=	

The bona fide debt per franchise figure of $[redacted] differs from the court's approximation of $[redacted]. (Petitioners' computation of the bona fide debt per franchise yielded $[redacted] which is closer to the court's figure). This difference can be explained through the difference in the present value factors in column (a) versus column (b) in Tables IV and VI in Treas. Reg. § 1.483-1(g)(2). Respondent used column (b), but petitioners used column (a).

ANALYSIS

Issue (1)

In determining whether I.R.C. § 483 is applicable to any payment which is not otherwise excluded, it must first be determined whether there exists any "total unstated interest." This term (i.e., total unstated interest) was defined in section 483(b) as an amount equal to the excess of the sum of the payments to which section 483 applies which are due under the contract over the sum of the present values of such payments and the present values of any stated interest payments due under the contract. Section 483(c)(1) provides that the rate to be applied in determining whether there exists total unstated interest shall be at least one percentage point less than the rate to be applied if there is total unstated interest.1/

Present value is determined under the tables set forth in Treas. Reg. § 1.483-1(g)(2), which apply a discount based upon the prescribed rate. The "test rate" discussed in section 483(c)(1) is found in column (a) of the appropriate table contained in Treas. Reg. § 1.483-1(g)(2) and the rate for determining the present value of a payment once it is determined that total unstated interest exists is found in column (b). See Treas. Reg. § 1.483-1(d)(1)(i).

It is well settled that Treasury Regulations constitute contemporaneous constructions by those charged with the administration of the tax laws and must be sustained unless unreasonable and plainly inconsistent with the revenue statutes. Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948); Bingler v. Johnson , 394 U.S. 741, 749-750 (1969). The efficacy of the regulations promulgated under section 483 has been consistently upheld by the courts. See, e.g., Robinson v. Commissioner, 54 T.C. 772 (1970) aff'd 439 F.2d 767 (8th Cir.

1/ Reference herein is made to section 483 prior to the amendments made by P.L. 98-369, P.L. 98-612, and P.L. 99-121. Because the instant sales took place on [redacted], the referenced amendments are not applicable. See Prop. Treas. Reg. § 1.483-1(e), 51 Fed. Reg. 12038 (1986).

1971), concerning the validity of the section 483 regulations as applied to installment sales under section 453, and Kingsley v. Commissioner, 662 F.2d 539 (9th Cir. 1981), aff'g 72 T.C. 1095 (1979), concerning the validity of the section 483 regulations as applied to the defined delivery of stock in a section 354 reorganization.

Because the sales in the instant case took place on [redacted], the appropriate "test rate" is 6% simple interest per annum. Treas. Reg. § 1.483-1(d)(1)(ii)(B) and Treas. Reg. § 1.483-1(g)(2), Tables IV and VI, Column (a). However, it is not necessary to apply a test rate to determine if there exists total unstated interest in the instant case because the court has determined that total unstated interest exists, and section 483 is applicable. See [redacted] at [redacted], wherein the court states "... [redacted] (emphasis added). Therefore, the relevant inquiry is the amount of total unstated interest. Treas. Reg. §§ 1.483-1(c) and (d)(1)(i). The amount of total unstated interest is computed by using the following formula:

Total Unstated Interest = Sum of the payments to which section 483 applies minus (Sum of the present values of such payments plus Sum of present values of any stated interest payments.)

See former section 483(b) and Treas. Reg. § 1.483-1(c).

In computing the sum of the present values of the payments to which section 483 applies, the higher interest rate prescribed in Treas. Reg. § 1.483-1(c)(ii)(B), which is 7% per annum compounded semiannually, is used. Treas. Reg. §§ 1.483-1(c)(2)(ii)(B) and (d)(1)(i). This higher rate is reflected in column (b) of the appropriate tables set forth in Treas. Reg. § 1.483-1(g)(2). In this regard, the use of column (a) in the appropriate tables for determining the present value of a payment is specifically prohibited by the regulations. See Treas. Reg. §§ 1.483-1(c)(2)(i) and (g)(1).

Since the court has already determined that total unstated interest exists, the next step is to compute the amount of the total unstated interest. This step is done by using column (b) in the appropriate tables to compute the present values of the payments. Treas. Reg. § 1.483-1(g)(1). Therefore, petitioners erred in using column (a). Accordingly, your use of column (b) is correct and the computation was filed as unagreed pursuant to T.C. Rule 155(b) on [redacted].

Issue (2)

Petitioners argue that any payments made by them toward their ECG terminal activity in subsequent taxable years, regardless of whether such payments are minimum payments on the notes or otherwise, will increase their amount at risk for such subsequent years. You indicate that your review of section 465 leads you to the conclusion that any cash payments made by petitioners in subsequent taxable years would increase their amount at risk.

Based upon section 465(b)(1)(A) and Prop. Treas. Reg. § 1.465-22(a), we are in general agreement with your conclusion. See also Jackson v. Commissioner, 86 T.C. 492, 536 (1986); [redacted] at [redacted], n.[redacted]. However, petitioners' amount at risk will increase as a result of the principal amount of any payments made toward the portion of each note determined to be bona fide debt by the court.2/ Any portion of a payment that is determined to be imputed interest under section 483 does not increase petitioners' amount at risk. See Prop. Treas. Reg. § 1.465-25(b)(2) and Rev. Rul. 77-397, 1977-2 C.B. 178.

In this regard, we also note that petitioners' amount at risk would increase upon payment of the $[redacted] note conversion fee and the $[redacted] franchise renewal fee. See e.g., Rev. Rul. 81-283, 1981-2 C.B. 115, wherein an investor's initial at risk amount included a cash down payment plus a fee required to convert the balance of a note to a nonrecourse liability. However, these amounts were also considered as part of petitioners' bona fide debt under the court's view. [redacted], at [redacted]. Consequently, the portion of such amounts that is considered to be imputed interest under section 483 will not increase petitioners' amount at risk.

Issue (3)

Petitioners argue that they are entitled to interest deductions for the amount of imputed interest under section 483 on the minimum payments made in subsequent taxable years. You correctly point out that under normal circumstances petitioners clearly would be entitled to a deduction for payment of imputed interest. Treas. Reg. § 1.483-2(a)(1)(ii). However, you believe that an ambiguity exists in the conclusions reached by the court.

On page [redacted] of the [redacted] opinion, the court states that the total amount of each note, $[redacted] does not represent true debt and, therefore, the $[redacted] minimum payments thereon are not deductible as interest for federal tax purposes. However, on pages [redacted] of the opinion, the court concludes that a section 483 calculation is necessary to determine the bona fide portion

2/ This, of course, follows from the Tax Court's holding that petitioners were not initially at risk with respect to the bona fide debt since [redacted] (the lender) had an interest in the activity other than as a creditor.

of the debt. You state that it is arguable that the court did not intend any portion of the minimum payments to be deductible as interest. Possibly, the use of the section 483 calculation in arriving at the principal amount of petitioners' bona fide debt was made solely to determine the allowable amount of amortization of franchise acquisition costs.

We agree that the opinion is somewhat confusing. However, when read in its entirety, we believe the court intended that its analysis regarding petitioners' bona fide debt be applied for all purposes. For example, in that part of the opinion concerning section 465, the amount of each note determined to be bona fide debt under the court's analysis was acknowledged. [redacted], at [redacted]. Additionally, in its discussion concerning whether petitioners' activities were entered into with a bona fide profit objective, the court stated:

[redacted]

A corollary to the court's statement that "[redacted]" is that a portion of such note is true indebtedness. It follows, then, that this corollary was also considered by the court in determining whether petitioners possessed a profit objective. Therefore, given that the court applied its bona fide debt analysis in the at risk discussion, the profit objective discussion and the basis discussion, it appears that such analysis was to be applied for all purposes. It follows that any portion of a payment that is determined to be imputed interest under section 483 is intended to be treated as such for all purposes, including section 163.

The court's opinion appears to be unusual in regard to its application of section 483 in finding a portion of petitioners' debt to be bona fide. However, an analogy to such approach may be found in Rev. Rul. 82-224, 1982-2 C.B. 5. In that ruling, a partial recourse, partial nonrecourse note was given as part of the purchase price for certain food storage containers. The ruling analyzed the note and treated it as two separate obligations. Section 483 was applied to the payments on the portion of the note treated as a recourse obligation, which had no stated interest rate, so that part of each payment would be treated as interest. Although the primary purpose of Rev. Rul. 82-224 was to determine the taxpayers' basis in the property, the ruling does not purport to limit the section 483 analysis to

the computation of basis. Rather, Rev. Rul. 82-224, containing no limiting language as to the deductibility of imputed interest, must be read as comporting with other revenue rulings that allow the deduction of imputed interest in accordance with sections 163 and 461. See, e.g. Rev. Rul. 72-408, 1972-2 C.B. 86, Holding (10).

In light of the above and in view of the general rule that imputed interest is deductible by a cash basis taxpayer when paid, it appears that no argument is available to deny petitioners such deduction. Treas. Reg. §§ 1.483-1(a)(1) and 1.483-2(a)(1)(ii).

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